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**California State Board of Equalization**
450 N Street
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**Subject: Written presentations on capitalization rates and other factors and procedures affecting the FY 2013-14 values of gas storage facilities**

Industry Background

The California State Board of Equalization ("the Board") annually assesses various industries and companies that are classified as gas and electric. Within the gas and electric industry, there are a number of companies that specialize in natural gas storage. While gas storage has been around for more than 50 years, revitalization in gas storage occurred in the early 2000's. This resurgence was the result of natural gas shortages and rising prices that occurred during those years. Because of this resurgence, increase investment in gas storage properties was made by several companies. These companies' business operations are regulated by the California Public Utilities Commission (CPUC). The regulation is dissimilar to the traditional regulation that is associated with most gas and electric companies that provide service to CA residences and businesses.

A major difference in regulation is that gas storage companies are not subject to cost of service rate regulation. This means that these companies can charge market rates for their storage service. In short, gas storage rates are based on the competitive market environment. A very basic example that determines the storage rates is what a customer is willing to pay to have its gas injected and stored in California during summer months (nonpeak period) and then withdrawn and sold for use during winter months (peak period).

Because natural gas prices can vary from lows in the summer months to highs in the winter months, this creates an opportunity for a business model where gas is purchased low and sold high, in what is called a "price spread". However, this requires that for the months in-between the gas must be stored, and storage should be located close to the point of consumption. This is where the gas storage companies step in. Because there is a cost to store gas, the price spread must be great enough for the gas supplier to be able to incur storage costs.

In the mid-2000's, natural gas storage margin spreads were greater than what they are today. For example, during the early 2000's, expected storage margins were $1.00 mcf or greater. Currently margins have dropped to around a third of this. The gas storage industry investment was based on the higher margins. The current margins do not support the investments that are on the books at this time.

Overall, gas storage has been impacted negatively due to the lower natural gas prices. While prices are said to have rebounded slightly in recent months, analyst do not expect natural gas prices to rise materially above the $4 MMBtu in the years to come due to adequate inventory levels, strongly impacted by the shale gas phenomenon. Due to the expectation that natural gas prices will remain relatively low for the foreseeable future, there is little hope that the natural gas storage industry will return to a level of profits seen in the mid 2000's. This is also supported by a lack of natural gas price volatility, low natural gas storage inventories, and lower prices and shorter terms on renewed storage contracts.

## Valuation Methodologies

Currently the Board values these market rate gas storage companies using a Replacement Cost New less Depreciation (ReplCLD) indicator and a Capitalized Earning Ability (CEA) indicator. Generally the greater reliance is place on the ReplCLD indicator. For a new company or new industry, greater reliance on the ReplCLD indicator may be appropriate. However, for an industry that has been impacted by such negative economic change over the past three years, and which is not expected to recover any time in years to come, the ReplCLD indicator is less reliable for valuing the property. Greater or greatest reliance should be placed on the CEA indicator considering that a buyer would not pay more than the property's discounted expected income.

Very Truly Yours,